

Part I

Section 163.—Interest

(Also: Sections 469, 702, 703)

Rev. Rul. 2008-12

ISSUE

Is a noncorporate limited partner's distributive share of partnership interest expense incurred in the trade or business of trading securities by the partnership subject to the limitation on the deduction of investment interest in § 163(d) of the Internal Revenue Code?

FACTS

PRS is a partnership that is engaged solely in the trade or business of trading securities for its own account and not for customers. LP is a taxpayer other than a corporation (a noncorporate taxpayer) that owns an interest in PRS as a limited partner. LP does not materially participate (as that term is used in § 469) in the activity in which PRS is engaged.

PRS incurs indebtedness in its trade or business of trading securities. LP's distributive share of the income, gain, loss, deduction, or credit of PRS includes interest expense incurred on this indebtedness.

LAW AND ANALYSIS

Section 703 provides that the taxable income of a partnership is computed in the same manner as an individual, except that items described in § 702 must be separately stated and certain deductions are not allowed to the partnership.

Section 702(a)(7) provides that each partner in determining its income tax is required to take into account separately its distributive share of the partnership items of income, gain, loss, deductions, and credits to the extent provided by regulations.

Under § 1.702-1(a)(8)(ii) of the Income Tax Regulations, each partner must take into account separately its distributive share of any partnership item that, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately.

Section 1.702-1(b) provides that the character in the hands of a partner of any item of income, gain, loss, deduction or credit is determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.

Section 163(a) provides that, in general, a deduction is allowed for all interest paid or accrued within the taxable year on indebtedness. Section 163(h)(1) provides that a noncorporate taxpayer is not entitled to a deduction for personal interest paid or

accrued during the taxable year. Section 163(h)(2) provides that personal interest does not include interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee) or investment interest, as defined in § 163(d).

Section 163(d)(1) provides that the amount allowed as a deduction for investment interest for any taxable year by a noncorporate taxpayer shall not exceed the amount of the taxpayer's net investment income for the taxable year. Section 163(d)(3)(A) provides that the term "investment interest" means any interest allowable as a deduction that is paid or accrued on indebtedness properly allocable to property held for investment.

Section 163(d)(5)(A)(ii) provides that the term "property held for investment" shall include any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. Under § 163(d)(5)(C), the terms "activity", "passive activity", and "materially participate" have the meanings given such terms by § 469.

Section 1.469-1T(e)(6) provides that an activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity). The term "personal property" has the meaning provided for such term in § 1092(d) without regard to paragraph (d) thereof.

Section 1.469-4(a) provides that a taxpayer's activity includes an activity conducted through a partnership. Also, under § 1.469-2T(c), an interest in an activity

includes both an interest in property used in an activity and an interest in an activity held through a partnership.

The trading business of PRS involves the conduct of a trade or business which is not a passive activity. Because LP does not materially participate in the trading business of PRS, LP's interest in the trading business of PRS is an interest in an activity that is property held for investment within the meaning of § 163(d)(5)(A)(ii).

Accordingly, because LP's distributive share of the interest paid or accrued on the indebtedness of PRS is allocable to the trading activity of PRS, it is investment interest described in § 163(d)(3) and subject to the investment interest limitation in § 163(d)(1).

Because the degree of participation by each noncorporate partner of PRS could limit the deductibility of the interest expense allocable to its trading business, PRS must separately state this expense.

HOLDING

A noncorporate limited partner's distributive share of the interest expense on indebtedness allocable to the partnership's trade or business of trading securities is investment interest described in § 163(d)(3) and subject to the limitation on the deduction of investment interest in § 163(d)(1), if the limited partner does not materially participate in the trading activity.

DRAFTING INFORMATION

The principal author of this revenue ruling is Faith P. Colson of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information

regarding this revenue ruling, contact Faith P. Colson at (202) 622-3060 (not a toll-free call).